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# Islamic Banking

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# Summary

I - What is Islamic Banking?

II - Islamic Banking products & instruments

III - Examples of Islamic transactions

IV - BNP Paribas & Islamic Banking

Islamic Banking Unit

# I - What is Islamic Banking?

# I - What is Islamic Banking?

## Introduction:

The origin and bases of Islamic Banking banking is governed by the Sharia i.e. Islamic Law, sometimes referred to as Islamic jurisprudence.

Islamic Sharia law provides rules that encompass the allocation of resources, capital market activities, and the distribution of income and wealth.

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# I - What is Islamic Banking?

## Basic principles (1):

- Prohibition of any sort of interest ("Riba")

  No traditional deposit / loan / bonds / overdraft...

- Money is a capital not an asset:

  No pure monetary flows

  All transactions shall be asset-backed (e.g.: no derivatives / no short selling / no debt selling)

- Risk Sharing:

  suppliers of funds becomes investors instead of creditors.

  the provider of financial capital & entrepreneur share business risks in return for share of the profits.

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# I - What is Islamic Banking?

**Basic principles (2):**

• Prohibition of speculative Behavior or uncertain transaction (“Gharar”):

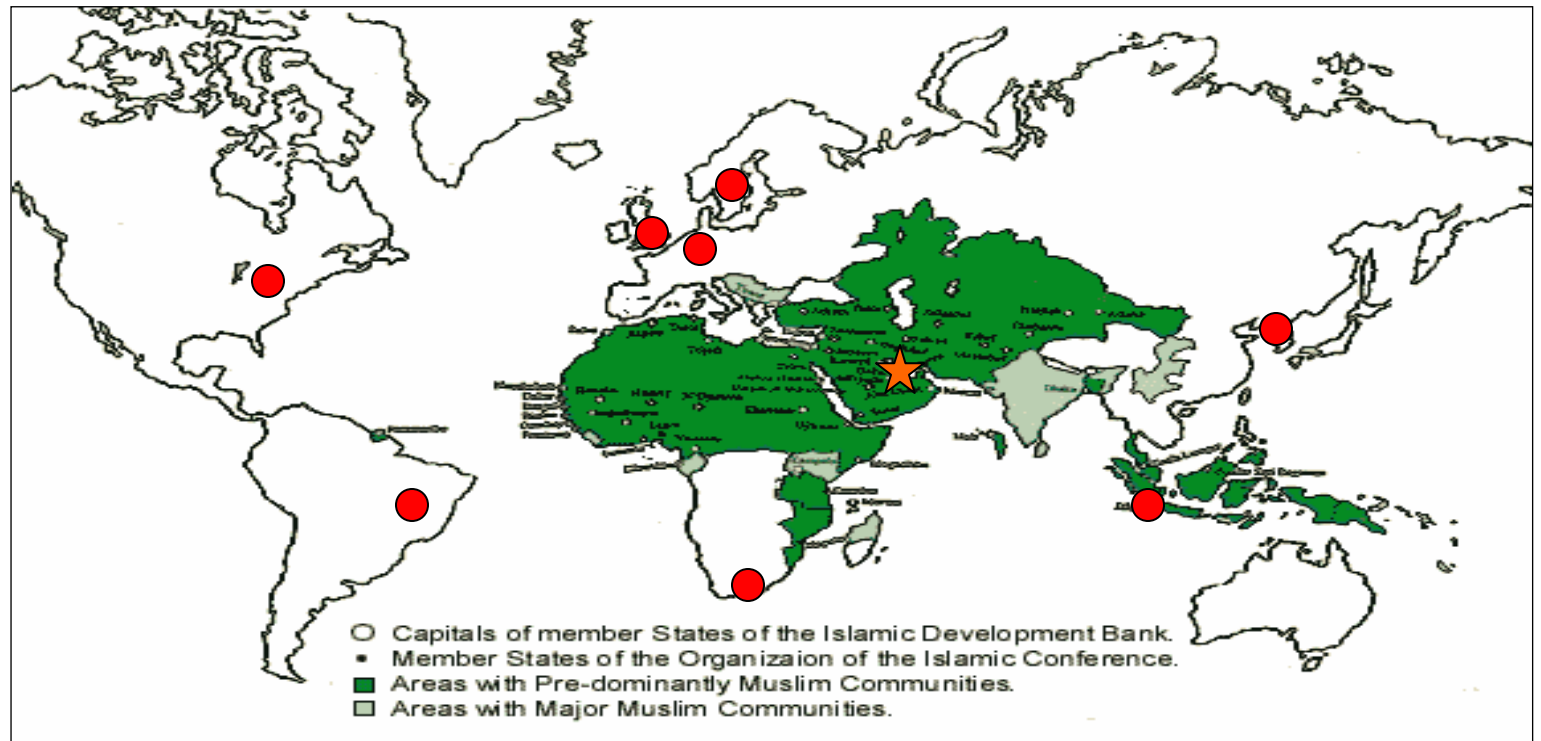
e.g.: conventional insurance contracts not allowed

• Transaction limited to Sharia-compliant activities

No pork / no alcohol / no arms / no hotels / no night clubs / no gambling

# I - What is Islamic Banking?

## Territory Coverage of Islamic Banking:

○ Capitals of member States of the Islamic Development Bank.
• Member States of the Organizaion of the Islamic Conference.
■ Areas with Pre-dominantly Muslim Communities.
□ Areas with Major Muslim Communities.

**Strong presence in Emerging Markets (eg. in SEA: Malaysia, Indonesia, Brunei, Philippines, Thailand...) and expanding to OECD countries**

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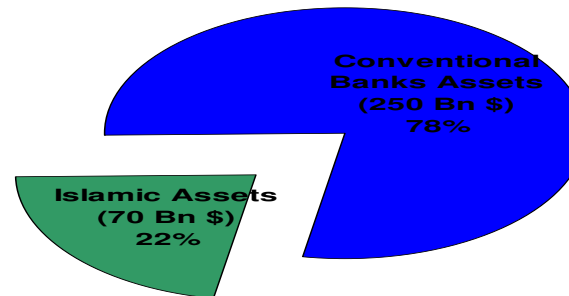
# I - What is Islamic Banking?

## Market Size: A young but fast growing sector

• Worldwide Muslim population: 1.3 Billion

• Sharia-compliant assets (within Banks) represents an estimated USD 250 billion,

• Of which USD 70 billion are in the GCC

• These assets are held by over 200 Islamic Financial Institutions

• Asset annual growth estimated at 15%

# I - What is Islamic Banking?

**Market Size: Asia as a leading actor for Sukuk**

•As of 03/09/2004 The Sukuk (Islamic Bonds) market is as follows:

- The world stock of sovereign Islamic bonds raised around US$ 2.7 billion
- In comparison, in Malaysia, the value of outstanding Islamic corporate bonds stand at nearly US$ 16 billion

⇒ Given the growing demand on these instruments, the Islamic debt capital market can and still need to be developed

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# I - What is Islamic Banking?

## Supervision & Regulation:

- Islamic Banks operate under general banking regulation
- Still in infancy Islamic Banks are also submitted like their Conventional counterparts, to:
  - Supervision by their Central Bank
  - General prudential regulations
  - Anti-Money laundering law regulations
- In addition to :
  - Accounting & Auditing Organization for Islamic Financial Institutions (AAOIFI - Bahrain) :
    - dealing in all matters related to accounting, auditing & governance rules
  - Islamic Financial Services Board / Banking Supervisory (IFSB - Malaysia)
    - set up and owned the relevant central banks
    - dealing in all matters related to Islamic Banks supervision

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# II - Islamic Banking products & instruments

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# Most of conventional products are available in a Sharia-compliant format

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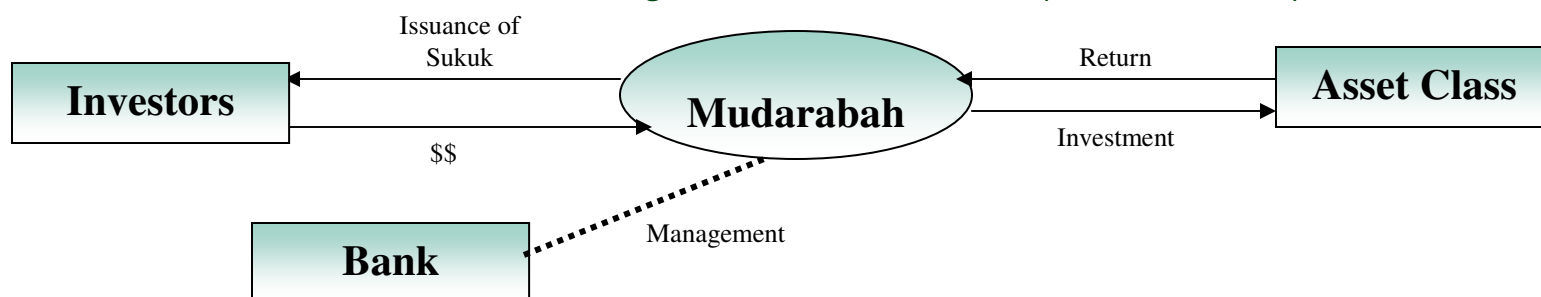
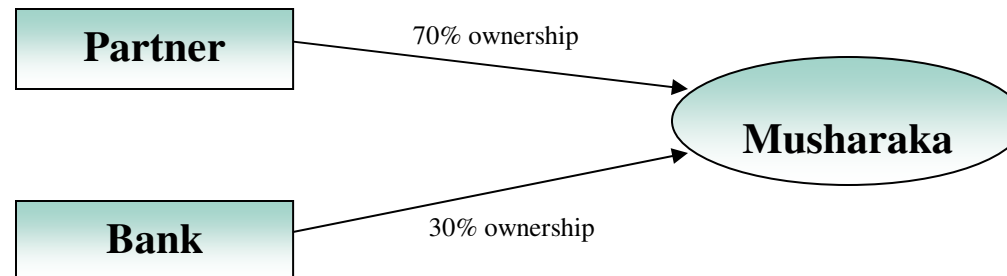
# II - Islamic Banking instruments & products

## Main Instruments (1):

• Murabaha: (cost plus sale) contracts in which a Financial institution purchase goods upon the request of a client, who makes deferred payments that cover the cost and an agreed-upon profit margin for the FI. It is the most widely used instruments in Islamic finance.

• Mudarabah: (profit sharing agreement) is a contract between investors, acting as silent partners, and a FI, acting as a fiduciary/manager, to invest in an activity or a pre-determined asset class that earns each partner an agreed-upon profit portion of the investment. Mudarabah investments may be made for a fixed terms and arranged through negotiable instruments (called Sukuk)

# II - Islamic Banking instruments & products

## Main Instruments (2):

• Musharaka: (equity participation) A Musharaka is a partnership between the FI and an enterprise in which the FI supplies working Capital. The FI and its partner share the profits which may be different from the proportions of capital contributed . Alternative: “Diminishing Musharaka” whereby the partner agrees to buy out the Bank’s share over a period of time

• Ijarah: (leasing) Ijarah is a lease purchase contract in which a FI purchase equipment or property and lease it to a Company (Operating Lease)

Ijarah wa Iqtina is the same as Ijarah except that the lessee is obliged to buy the leased asset at the end of the contract (Financing Lease)

# II - Islamic Banking instruments & products

## Main Instruments (3):

• Salam: A Salam is a short term agreement in which a FI makes full prepayments for future delivery of a specified quantity of goods on a specified date. A Salam is primarily a deferred delivery sale contract usually used for commodity finance. It is similar to a forward where delivery is in the future in exchange for spot payment. To mitigate the asset risk the FI can enter into a “parallel” Salam.

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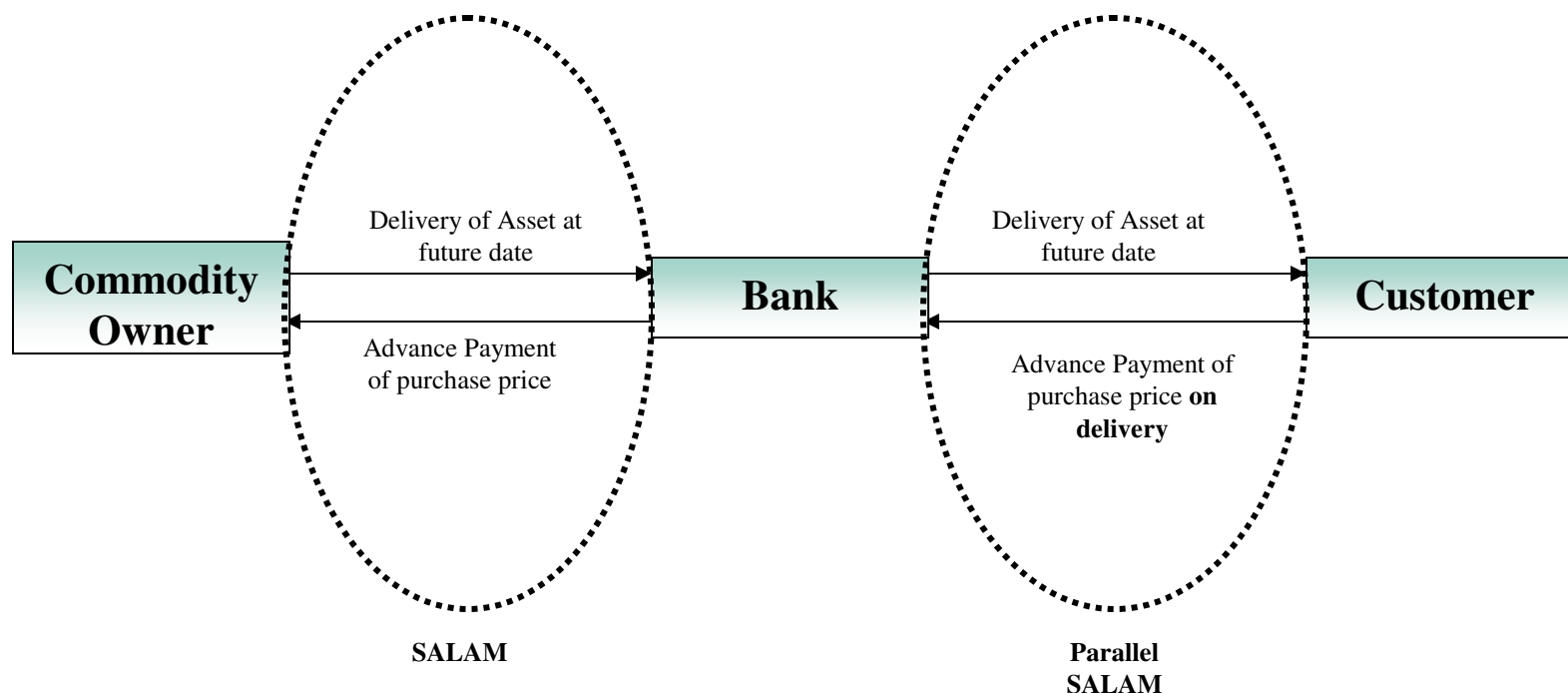
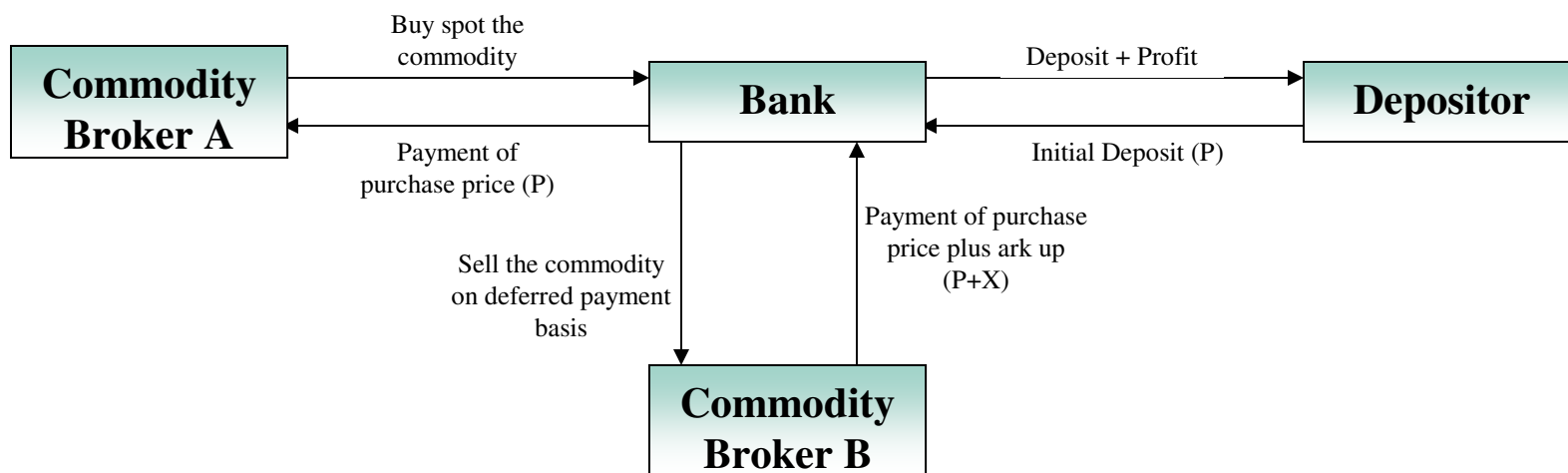

# II - Islamic Banking instruments & products

## Main Products (1):

- **Deposits:** Based on commodity Murabaha transactions:
  - The Bank acting as agent of the depositor, buys a commodity, spot value
  - The Bank instantly on behalf of its client sells the commodity at cost plus mark-up on a deferred payment basis.
  - On maturity the Bank pays to the depositor the profit (mark-up) plus the original investment.

- **Loans:** Loans can be structured the same way

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# II - Islamic Banking instruments & products

## Main Products (2):

• Islamic Bond (Sukuk): Based on the Mudarabah contract; the underlying asset can either be:

- A tangible asset bought (principal) by the Mudarabah from the issuer and leased back to him. On maturity the Issuer buys back the asset at its initial value. (Sukuk al Ijara: equivalent to a conventional bonds)

- A Murabaha entered into by the Mudarabah and the Borrower. (Sukuk al Murabaha according to the final structure it is either equivalent to a Syndicated Loan or a Conventional Bond)

- A Salam Between the issuer and the Mudarabah, and Parallel Salam Between the Mudarabah and the issuer. (Sukuk al Salam: equivalent to Treasury Bills or Zero Coupon Bond)

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# II - Islamic Banking instruments & products

## Main Products (3):

• Asset Securitization: Based on the Mudarabah concept and using assets such as receivables, rents or real estate.

• Islamic Investment Funds: Also Based on the Mudarabah contract; A lot of different types of funds can be structured:

- Equity Funds (Equity to be selected within DJI or FTSE Islamic)
- Capital Protect Funds
- Fixed Income (Sukuk) Funds
- Money Market Funds
- Real Estate/Leasing Funds
- Securitized assets (Aircraft, Ship...)

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# II - Islamic Banking instruments & products

## Main Products (4): BNP Paribas' Product range:

- ALM: **- Murabaha Deposit/Lending**
- Fixed Income:
  **- DCM Origination (Islamic Bonds...)**
  **- Asset Securitization**
  **- IR & Currency Derivatives**
  **- Credit Derivatives**
- Project Finance: **- Project Finance Tranches**
- Structured Finance:
  **- Asset Financing (Aircraft, Shipping...)**
  **- Islamic Syndicated Loan**
- E&C:
  **- L/Cs**
  **- Commodities Pre-Financing**
  **- Stock Refinancing**
- Asset Management:
  **- Capital protected Equity Fund**
  **- Equity Fund**

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# III -Examples of Islamic transactions

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# III - Examples of Islamic transactions

## Examples of Deals:

### 1) Sukuk Issuance

- Ijara Sukuk for Malaysia

• Description: in order for Malaysia to raise -in a Sharia Compliant way- mid-term funding, a Ijara Sukuk was structured; with features comparable to conventional bonds.

• Structure: An SPV bought and leased back to the issuing institution (i.e. Malaysia) certain tangibles assets. The purchase of the assets was funded by issuing Sukuk. At maturity, the assets, will be sold back to Malaysia at the initial price. The “coupon” for the investors will be represented by the rental payments paid by Malaysia.

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# III - Examples of Islamic transactions

## Examples of Deals:

### 2) Sukuk Issuance (2)

- Sukuk Al Murabaha for Malaysia

• Description: the lack of available of assets has been a hurdle to propose an Ijara or Mixed Asset Sukuk to potential issuers therefore BNP Paribas developed an innovative structure of Sukuk Issuance

• Structure: The SPV will raise funds from Investors by issuing Sukuk. The SPV will use the proceeds of the Sukuk issue to enter into a senior revolving Murabaha facility agreement (the "Murabaha") with the Ministry of Finance of Malaysia.

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# III - Examples of Islamic transactions

## Examples of Deals:

### 3) Securitization of the Swedish Post Office Outlets (launched in 2002)

• Description: Outlets of the Swedish Post Office were sold to and leased back by an SPV owned by Islamic Investors. At maturity Outlets will be sold back.

• Amount of the Deal: Euro 330 mn

• Maturity: 15 years

• Return for Investors: minimum of 8% p.a.

• Arranger fee: n/a

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# III - Examples of Islamic transactions

**Examples of Deals:**

**5) Air France / British Airways / Air Canada, Planes "refinancing" deal (launched in 2002)**

- Description: 21 Planes owned by the 3 above mentioned companies were sold to a Fund especially set-up for this deal. The planes were then leased backed to the Air company.
- Amount of the Deal: USD 150 mn
- Maturity: 5 years
- Return for Investors: 5% (fixed)
- Arranger fee: n/a

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# III - Examples of Islamic transactions

## Examples of Deals:

## 6) Al-Hidd Power and desalination Plant (arranged by BNP Paribas in 2002)

- The structure :
  - An SPC was set up and raised funds by issuing Sukuk. Those funds were then given to the Kingdom of Bahrain (KOB) as an advanced payment for future purchase of the whole asset
  - Construction period: on milestone dates, corresponding to the delivery of partial asset from the contractor to KOB, legal titles on these partial assets were immediately transferred from KOB to SPC and then leased back to KOB.
  - At the completion of the asset, lease agreements on partial assets were repackaged as a single lease agreement for the whole asset for a period of 12 years

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# IV - BNP Paribas & Islamic Banking

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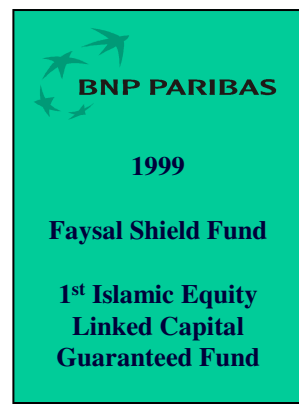
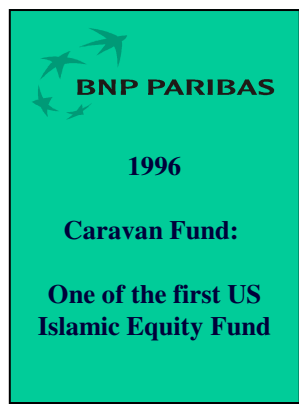
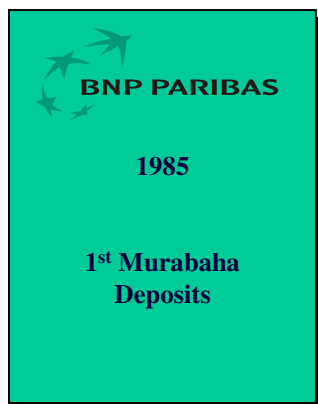
# BNP Paribas: 19 years in Islamic Banking

Islamic Investment Department within BNP Paribas with dedicated multi-product capabilities:

- Large short term deposits base i.e. murabahas since 1985

- Co-arranger in Project Finance Islamic tranches

- First Islamic capital protected fund structured by BNP Paribas

- One of the first Islamic Equity fund

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# IV - BNP Paribas & Islamic Banking

## Our Set up :

Selected Panel Of Clients

Origination & Marketing

**Islamic Banking Unit:**
Head: J-M Riegel
Dty. Head: A. Raad

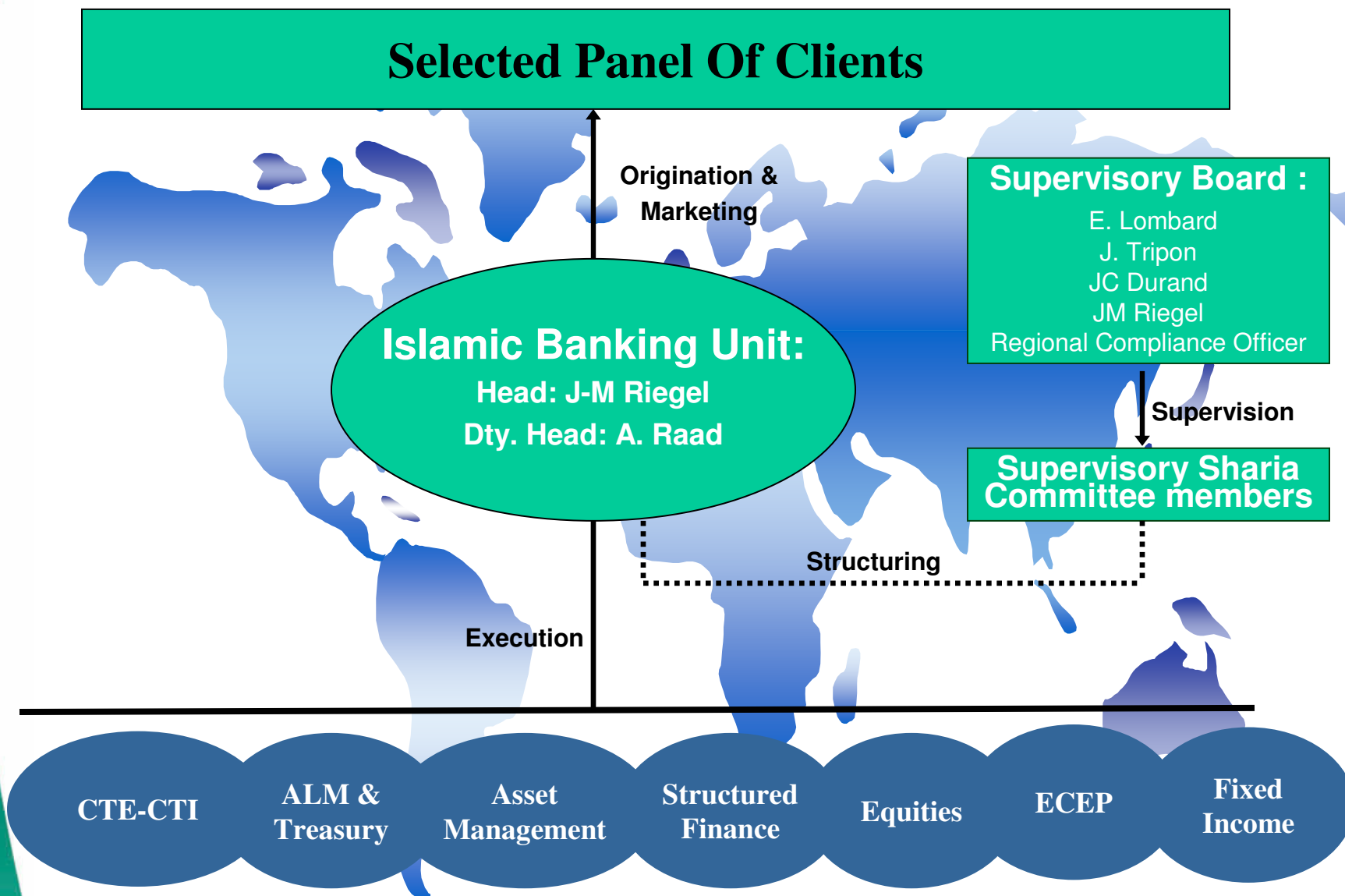
**Supervisory Board :**
E. Lombard
J. Tripon
JC Durand
JM Riegel
Regional Compliance Officer

Supervision

Supervisory Sharia Committee members

Structuring

Execution

CTE-CTI | ALM & Treasury | Asset Management | Structured Finance | Equities | ECEP | Fixed Income

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# IV - BNP Paribas & Islamic Banking

## Our Sharia Supervisory Committee:

BNP Paribas SSC is composed of well-known and highly commended scholars.

**Dr. Nizam Yaquby - Bahrain (Chairman of BNP Paribas' Sharia Supervisory Committee)**
Educated at both the McGill University in Canada and the University of Wales. Has studied under the guidance of some of the world's pre-eminent Islamic scholars. Gained over twenty years of experience in teaching Islamic business subjects and has written several research papers on these topics. Is considered a Sharia advisor to many international financial institutions and insurance including, The Dow Jones Islamic index.

**Dr. Abdul Sattar Abu Ghuddah – Syria (based in Saudi Arabia)**
Educated in both Damascus and Al Azhar University, Egypt. Is part of several Sharia Boards of financial institutions internationally, including that of The Dow Jones Islamic Index. Has researched and published numerous studies on Islamic banking. Dr. Abu Ghuddah is a member of the International Islamic Fiqh Academy as well as the Islamic Accounting & Auditing Standards Board.

**Dr. Mohamed Daud Bakar - Malaysia**
An Islamic scholar educated at the University of Kuwait and at the University of St. Andrews in Scotland. Dr Daud Bakar is the Deputy Rector and an Associate Professor in Islamic Law, at the International Islamic University in Malaysia. He has published a considerable number of research papers and has participated in numerous seminars and conferences on Islamic banking and finance. Dr Daud Bakar is as well, a Sharia consultant and advisor for several financial institutions around the world including, Bank Negara Malaysia and the International Islamic Financial Market in Bahrain.

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# Thank You for your Attention